Assessment and recommendations

Growth is strong and macroeconomic imbalances are being reduced, but unemployment remains too high

The Slovak economy is on a high growth path driven by growing foreign direct investment (FDI) inflows, attracted by a favourable operating environment in a country soon to be integrated in the EU. It is striking in that connection that, with labour costs remaining the second lowest in OECD, Slovakia is set to become the top OECD manufacturer of cars per capita next year. Real GDP is growing at around a 4 per cent annual rate, exports are expanding steadily and private domestic demand is robust. The current account deficit has returned to a more easily sustainable level. Wages are rising in line with labour remains subdued as local businesses lag the highly productive FDI firms, and domestic services and self-employment remain underdeveloped. Willingness to work is also undermined by a welfare system which has been extremely generous for a long time. The resulting unemployment, concentrated among the low skilled, the young and the elderly outside the Bratislava area, remains very high (at 17 per cent on a survey basis in the fall of 2003) and will come under additional pressure as a result of job cuts in general government and public utilities.

Economic policy faces three main challenges…

The authorities face three main challenges. First, their aim of joining the euro area as soon as the nominal convergence criteria will have been met on a sustainable basis sets a demanding macroeconomic agenda. A significant reduction in fiscal deficits is required, not only to meet the fiscal rules but also to pursue disinflation objectives without an excessive tightening of monetary conditions that would impact negatively on growth and employment creation. Second, the employment rate needs to be raised through radical changes in the incentives to both supply and demand of labour while maintaining households' confidence and political support for government policies. The recently introduced legislation to strengthen work incentives should be fully enforced. Third, there is an obvious need to push for smaller and more effective government, against a strong constituency in favour of maintaining the status quo which entails one of the highest shares of general government jobs in total employment among OECD economies. Public sector reform is necessary not only to support fiscal consolidation but also to promote a pro-growth environment. Radical transformations are needed in the public sector to assert the rule of law, to enforce impartial and reliable business regulations, and to develop more effective infrastructures for education, training and transportation across the territory.

... which are intended to be met by a bold reform programme...

The new government elected in September 2002 initiated a set of major reforms in the face of these challenges. On macroeconomic policy, the authorities have formally committed to curbing fiscal deficits on a sustained basis, thereby alleviating the burden of economic stabilisation on monetary policy. The independent Central Bank has already been successful in pursuing its disinflation policies, but fiscal consolidation is required to allow for more supportive monetary conditions. The government has also begun to stimulate labour supply and demand with major measures. Welfare benefits available for able-bodied citizens remaining voluntarily unemployed are being massively reduced, while the retirement age is being increased and pension benefits made dependent on work and contribution history. Employers' incentives to hire are being strengthened by labour code reforms making both permanent and temporary job creation less costly; and targeted employment subsidies will be introduced in 2004 for the long-term unemployed. Incentives for small size businesses and the self-employed have been increased by sharp reductions in both the corporate and personal income tax rates, by easing the regulatory environment for businesses, and by adopting competition and public procurement policies that facilitate new entries.

... where interaction between policies is essential

Each of the individual components of this bold reform programme – launched only a year ago and still in the process of being put into application – is important on its own right, but the contribution to overall economic success will be magnified through the interactions among these reforms. The private sector's response to enhanced incentives for investment and job creation is of central importance, and could well exceed the temporarily adverse impact of fiscal consolidation, net of monetary easing, on growth and employment. More competition and new entry in services should facilitate disinflation and help reduce the inflation gap between tradables and non-tradables, while labour market reforms should further enhance the nominal flexibility of wages and help monetary policy to attain inflation objectives. The impacts of this reform package on the living conditions of the low-skilled and long-term unemployed is a legitimate concern, but short-term strains are expected to be offset by increased employment. Nevertheless, additional measures may be needed. As unemployment rates differ significantly with respect to educational achievement (the proportion of the 25-to-64 year old males in unemployment ranges from 4.5 per cent for those with tertiary education to 44 per cent for those with less than upper secondary education) training policies should focus on improving the re-employment prospects of the disadvantaged groups. The policy challenge, for both growth and equity reasons, is to fully reap the latent synergies between macroeconomic, labour market, business sector and public sector reforms.

Fundamental tax reform aims at enhancing efficiency

A comprehensive tax reform has been launched to enhance incentives for entrepreneurship and work, increasing the transparency of the tax system, and reducing distortions from exemptions and double taxation. The core of the reform consists of a flat marginal rate of 19 per cent on all personal and corporate incomes, while the deductible allowance for low income earners is increased. Virtually all tax exemptions are eliminated, whereas the real estate transfer, gift, and inheritance taxes are abolished. A uniform value-added tax rate of 19 per cent is applied to all products and entails a major shift in the tax burden from direct to indirect taxes. These changes have become effective from January 2004 and should enhance efficiency by treating different forms of income more equally. According to official projections, the overhaul of the tax system should be revenue-neutral, but the multi-faceted nature of the changes and data limitations on household incomes make projections tentative. The authorities should provide for contingency plans and measures to face any revenue shortfalls upon implementation in 2004.

Monetary policy has been fulfilling its tasks but faces a big challenge in managing the transition towards euro adoption

The Central Bank has been successful over the past several years in furthering disinflation despite large, though necessary adjustments in administrated prices towards cost-recovery levels. Disinflation has been helped by currency appreciation and international price moderation, but the key to successful disinflation thus far has been the ability of the Central Bank to contain second-round effects of administered price hikes through active policies. Core inflation has been kept slightly below the target range of 3.2 to 4.7 per cent in 2002 and within the target range of 2.1 to 3.6 per cent in 2003. Over the same period the trend appreciation of the currency has been kept on a smooth path, broadly in line with productivity gains, in spite of the strong capital inflows associated with EU accession. Monetary policy will need to continue on its present narrow path between inflation targets and competitiveness considerations. This may become a challenging task in view of possible volatility in capital flows prior to participation in the euro area, as pressures for appreciation are likely to increase and the need for interventions and sterilisation may grow. In these circumstances fiscal consolidation must be geared to alleviate the burden on monetary policy.

Rapid fiscal consolidation is required

The fiscal position on a cash basis continues to be undermined by the lasting effects of the distortive policies of the mid-1990s, notably the ex-post costs of massive government credits and guarantees granted during that period. Furthermore, important tax cuts since 2000 have decreased government revenues and made fiscal management more difficult. Budget deficits were nevertheless beginning to be tamed in 1999 and 2000 before ratcheting up strongly in the run-up to the 2002 elections. The 2002 deficit reached 7.2 per cent of GDP on an ESA-95 (European System of Accounts) basis. In 2003 the new government succeeded in building up support for a rapid Maastricht criteria compliance strategy, and this underpinned a first cut at consolidation, with a targeted ESA-95 deficit below 5 per cent of GDP. The authorities have stated their intention to reduce the general government deficit below the Maastricht benchmark of 3 per cent of GDP by 2006. This amounts to a fiscal consolidation of more than 1 per cent of GDP per year. Such a consolidation path is appropriately ambitious, but achieving it will require a substantial effort. The major risks to this strategy pertain to possible spending slippages, notably in health care, and to the uncertain revenue impacts of the tax reform planned for 2004.

… and should be implemented through a medium-term fiscal strategy

In these circumstances, a medium-term fiscal consolidation strategy is indispensable to keep fiscal outcomes in line with objectives on a sustainable basis. The government aims at developing such a policy. The latest pre-accession economic programme submitted to the EU presents medium-term objectives which can be made more visible to the public and more operational in domestic policymaking. To this effect, the government intends to submit a three year budget framework to the Parliament starting with the 2005 draft budget. The medium-term objectives of this framework should be explicitly based on strategic spending priorities and conservative macroeconomic assumptions, and contain built-in adjustments to contingencies on both the spending and revenue sides. Making such framework conditions binding is a politically challenging task, but the government should seek to achieve this.

Strong incentives are being introduced to stimulate work…

Major reforms have been introduced to sharpen the incentives to work. The welfare system is being overhauled, cutting benefits by one half for the able-bodied citizens who remain voluntarily unemployed. Slovakia still remains the country with the highest unemployment rate for the low-skilled in the OECD area (at close to 40 per cent), and with the lowest employment rate of the population aged 55 to 64 (at close to 20 per cent). The pension reform voted in 2003 directly links benefits to contributions and thereby improves work incentives. Child and family benefits are also being reformed and will be distributed partly as tax bonuses in order to reward earned incomes. Registration for unemployment, a condition for getting access to welfare benefits, is also being made tighter in order to exclude employees working in the informal economy. These measures can be expected to substantially increase the willingness to work. To enhance the employability of the jobless and upgrade employment services, new measures have been voted by the Parliament and further initiatives are under way. The efficacy of such policies is particularly important for the Roma minority which represents about 8 per cent of the total population but 50 per cent of the long-term unemployed, partly as a result of functional illiteracy related to inadequate basic education. While international experience is that the returns to basic education for adults are low, substantial investment in adult education and training seems warranted in the Slovak context.

… and labour demand

Major reforms have also been launched to activate labour demand. Changes introduced recently in the labour code have simplified procedures for hiring, firing and reassigning employees and facilitate temporary and overtime work. Further cuts in social contribution rates, which remain among the highest in the OECD area and bear heavily on the low-skilled, must be a priority for future changes in the tax-benefit system. As a proxy for such cuts, targeted employment subsidies amounting to 30-40 per cent of total employment costs have been announced for enterprises hiring the long-term unemployed in high-unemployment regions. This measure is welcome, and sufficient funding should be secured in order to cope with a hopefully positive response by the private sector. Additional reforms broaden further the basis of growth beyond the FDI-core sector, by encouraging self-employment and small scale businesses in job-intensive service activities. While a key stimulus is provided by the tax reform, a simplified legal framework for enterprise registration is being introduced and reformed collateral rules should facilitate credit provision to small firms. Public procurement and competition policies are also being strengthened to create a level-playing field for all enterprises. It is intended to equalise business conditions – and improve tax collection – by prosecuting unregistered economic activities. This makes the reform of the social contribution system all the more important: entrepreneurs moving out of the informal sector can survive if their formal obligations remain commensurable with their ability to pay; some transition measures to assist such move could be contemplated.

The enforcement of the new institutional framework necessitates more effective government…

More fundamentally, what is required is a more effective and more reliable court system, including for the registration of new businesses and the handling of bankruptcies. Better staffed and resourced competition authorities to deal with predatory and other anti-competitive practices, and credible sectoral regulators governing the energy, transportation and communications infrastructures are also needed to underpin a market-friendly legal environment. Small enterprises which have no political leverage on the government to protect their property rights, and no direct bargaining power *vis-à-vis* incumbent utility firms need such a framework. Little progress has as yet been achieved in the governance of the court system, the credibility of the police and the assertiveness of economic regulators; and shortcomings are regularly reported in the implementation of various components of the new legal framework. The government is aware of these problems and new laws are being prepared on *conflicts of interest* in public office and the *asset-declarations* of elected officials and civil servants. These efforts require time to obtain results, and the resistance shown by private interests needs to be rapidly overcome.

… including in the areas of environmental policy and tax collection

There is a recognised need for less costly environmental policies, which will become more binding and more demanding, especially for small enterprises, in the course of EU accession. A wider recourse to economic instruments is advisable and this will require an improvement in public management capabilities. In the area of air quality which has been a serious concern in Slovakia, fuller recourse to emission charges and tradable emission permits would reduce regulatory costs. Another area where public management capabilities must be enhanced is tax collection. Wider use should be made of individual tax returns for a more integrated management of tax, welfare, family and other benefits and incentives. Finally, Slovakia's ability to fully draw on available EU Funds for its public and infrastructural investments also depends on the quality of its public service.

A thorough public sector reform is required…

The core challenge faced by the government is to substantially enhance the quality and efficiency of public sector service delivery in a wide range of areas, while reducing its fiscal costs. The dilemma is not insurmountable in the Slovak context because of the very large inherited inefficiencies built into public spending. The new government is engaged in a fundamental overhaul of the public spending system on the basis of reforms in three areas:

– the introduction of strategic and performance based budgeting,

– decentralisation and subsidiarity in the provision of public services, and

– a thorough transformation of the public employment regime.

These ambitious measures have been launched only recently and are in their teething phase. It is important to implement them effectively in order to maximise their benefits, increase their credibility and exploit their synergies.

… including strategic and performance-based budgeting…

Fiscal consolidation should not be based uniquely on spending limits. The most needed adjustments and improvements in government services, public employment and social transfers do not automatically follow from budget cuts. OECD countries' and Slovakia's own recent experience shows that across-the-board cuts may bring about undesirable consequences such as infrastructure attrition, adverse selection in the quality of civil servants, and increased room for corruption in the conduct of public affairs. Targeted reductions in service capacities in lower priority areas are preferable, even if designating such targets is politically more difficult than across-the-board cuts. Strategic and performance-based budgeting are essential tools for this purpose and the government plans to generalise them in the forthcoming budgets, on the basis of lessons from ongoing pilot experiences. Strategic and performance-based budgeting should be utilised more actively to reallocate spending, from lower to higher priority areas.

… decentralisation and subsidiarity in the provision of public services…

Following a set of laws voted in 2001 and further executive decisions in 2003, Slovakia is making a leap forward in regionalisation. Responsibility for providing the main public services, including education, health, railway and social welfare services, have been transferred to sub-central governments as of 2003. Sub-central layers are still funded by the central government, but transfers will be less and less tied to specific uses, and funding will be secured mostly by bloc grants from 2005. This is expected to give regions and municipalities incentives for savings and service improvements so that the central government will be able to scale back overall funding in line with the efficiency gains generated by decentralisation. While this ambitious reform offers opportunities for expenditure rationalisation, it also presents risks. Sub-central governments may become more effective than the central government in the provision of services but only if they remain fully accountable to local constituencies and are liberated from supplier interests. The central government should define and enforce core performance standards to ensure the quality of the public services across the territory, but needs to avoid micro-management to prevent weakening the accountability of sub-national governments. Sub-central governments are subject to quite detailed fiscal disciplines specified in the decentralisation laws, and these disciplines must be strictly enforced, including with respect to possible off-budget loopholes. Full fiscal transparency at sub-central levels through regular procedural and functional audits must be ensured. Perhaps most importantly in a longer-term perspective, user satisfaction and service performance should be closely monitored across regions and the comparative information made public. The development of a "culture of transparency" through this means would, over time, substantially ease the conflict between the goals of decentralised responsibilities and globally sound public finances.

… and an overhaul of the public employment regime

A new public employment regime has been put in place to provide for quantitative and qualitative changes in public sector employment. The new State Service Act prescribes the needed qualifications and the contractual provisions for 36 000 central administration jobs, and a Civil Service Act specifies corresponding provisions for more than 400 000 general government work positions, including in sub-central governments. Detailed procedures for the verification and certification of the required skills and qualifications, with related adjustments in the contracts offered, are meant to facilitate the firing of unqualified persons and their replacement by new recruits. The early experience with the implementation of this framework has been disappointing. The examinations and tests could not be implemented, and no significant employment adjustment has been recorded on the basis of the new provisions. The regionalisation reform interferes somewhat with the enforcement of the new regime, as sub-central authorities have discretion over their own personnel management. In the short-run authorities need to evaluate the obstacles to the implementation of the new laws, which are fundamentally aimed at overcoming corruption and nepotism in public sector employment. At the same time, care must be taken to assure that these laws do not become barriers to flexibility and adaptation in the public sector to changing requirements.

Results will be particularly critical in education services...

A thorough reform of the education system is necessary, as emerging human capital needs are not well serviced at present. The government has decided to decentralise the ownership of primary and secondary schools to municipal and regional governments, and to fund expenditures according to the number of pupils in each region. Sub-central governments will be left with a wide discretion in the management of education institutions. International experience suggests that this is an appropriate choice. But this same experience suggests that the central government needs to define performance standards in order to preserve the quality of education across the entire territory. This is particularly important for the Roma children who face the double-handicap of weak support from family environments and high failure rates in the school system. The decentralised approach should allow sub-central governments to experiment with more effective policies to meet the set standards, including on the basis of increased competition between public and non-public schools. In the area of tertiary education, available capacity falls short of demand, and the government aims at encouraging pluralism and new entries by transforming universities into autonomous institutions and putting in place tuition fees and student loans. The authorities should ensure that professional and academic bodies which control the creation of new universities do not slow the adaptation of supply. Reforms are also necessary in the training and re-training system for the existing labour force. While large firms are well-equipped to cater to their own training needs, better performing market services would support the entire society. Market-relevant re-training is particularly important for adults with low or obsolete skills and government schemes should be targeted in priority towards these groups. The government can nurture a more effective training culture by directing existing subsidies on a competitive basis and according to provider performance.

… in infrastructures…

Small and medium sized firms need to obtain better access to fairly priced and high quality infrastructures. Programmed regulatory reforms in energy, telecommunications and transportation should be fully enforced and completed, in order to give firms of all sizes swift access to competitive services across the territory. Benefits of competition should be made available not only to large-size eligible customers, and to enterprises with strong bargaining power *vis-à-vis* incumbent utility firms, but to the entire business and household sectors. In certain areas such as railways, Slovakia could move more rapidly than the gradual calendar of EU directives. Following the recent separation of the track infrastructure as a state-owned company, the quality of the transportation system could be considerably strengthened by proactively opening passenger services to competition, and privatising the freight arm of the national railway company to a qualified international enterprise. Road construction should also be upgraded in better match with neighbour countries' networks and, possibly, with wider recourse to private investment. But lessons from public-private partnerships in road operation in the neighbouring Czech Republic and Hungary should be taken into account in designing projects so as to maximise public benefits while limiting fiscal liabilities.

… in the pension system…

The pension reform applicable from 2004 will enhance the public pay-as-you-go (PAYG) balances by increasing the statutory retirement age from previously 60 for men and 55 for women to 62 for both genders, which is a major step towards improving the viability of the scheme. The system remains nevertheless financially unsustainable in the long term. The planned defined benefit scheme with its strict link between contributions and benefits should, upon completion, transform workers' perception of pension contributions from quasi-taxes to quasi-savings. Further changes in the PAYG system are desirable, notably the standard retirement age should be raised progressively to 65 for both genders. A funded second pillar is planned to complete the system and to bring the necessary top-ups to the PAYG benefits which will decline as a percentage of average wages. Replacement rates will decrease sharply for low wage earners at the end of a three-year transition period, and authorities should check if trend wage growth will be sufficient to provide a minimum retirement income for all. A special issue related to the phasing-in of the second pillar concerns the fiscal compensation of the main pillar from the state budget, for the diversion of PAYG contributions. These may amount to about one per cent of GDP per year in the short-term and will likely increase in the following decades. As long as no agreement is reached with the European institutions for the exclusion of such compensation from current expenditures, Slovak authorities will be faced with a difficult choice between postponing or downscaling the second pillar reform, delaying convergence with Maastricht rules, or seeking yet further spending cuts.

… and in the health sector

The health care system is also being reformed with the primary aim of ensuring its financial viability by making all stakeholders accountable for their decisions, at least partially. Patients are to be presented with a clearly-defined basic benefit package and a structure of co-payments, both of which have been absent in Slovakia. The ownership of hospitals is being devolved to lower levels of government, and service providers are to face financial discipline imposed by for-profit insurance companies that compete for subscribers. While reform intentions are admirable, much will depend on the detail of the reform design and implementation, including the breadth of the basic benefit package, the size of co-payments and the regulation of insurers to generate incentives for improved efficiency rather than risk selection. Moreover, the deregulation of health prices and decentralisation will reduce the policy levers for costs control available to the government. It would therefore be prudent not to precipitate reform in this area nor to expect large near-term fiscal savings from it.

Summary

In sum, Slovakia is engaged in an ambitious reform process which has a potential to quicken productivity growth, increase the employment rate and accelerate the catching-up to the per capita income levels of more advanced OECD countries. Short-term outcomes may be demanding socially and politically, but stimulus to growth and job-creation should help overcome the hardship. Policymakers should fully enforce the new framework for creating and doing business and support it with the full force of law. Human capital enrichment for new entrants through education reform is critical, while intensified re-training for the long-term unemployed is also indispensable, including for the Roma population. Demand for labour will be stimulated by the planned reductions in employment costs in the low end of the market, as well as by the fundamental tax reforms raising the return to enterprise creation and development. Further cuts in social contributions, which remain among the highest among OECD countries, should be a priority. The reform of the public spending system, which is already well engaged, should facilitate such additional cuts and help promote a smaller and more effective government. Continuing efforts of fiscal consolidation will improve the macroeconomic policy mix and help maintain supportive monetary conditions in the face of currency appreciation pressures from EU accession, and will help meet the Maastricht nominal convergence rules on a sustainable basis prior to euro area participation. The nominal flexibility of wages and prices should be conserved in order to preserve the competitiveness of the economy, notably of the domestic manufacturing and service firms. By sticking to this multi-pronged policy agenda, Slovakia would make its growth process more balanced and more job-rich and would accelerate further its already successful catching-up process.

Notes

1. See Sabol and Hošková, 2003.
2. Around 5 per cent, up from 4 per cent a year ago. See monthly Dun & Bradstreet reports on the creditworthiness of 5 000 Czech and 1 000 Slovak firms About three quarters of endangered firms (category IV) are likely to go bankrupt within a year. Their likelihood of bankruptcy is 150-times higher than among the firms with best payments discipline (category I) (*www.dbis.cz/speng/press/press_release_0603.htm*).
3. Under the assumption that one quarter of employment in loss-making enterprises might disappear, which would imply a loss of about 7 per cent of total employment, and that rationalisation in the public sector would reduce the share of general government employment in total employment to the OECD average, which would mean a loss of about 3 per cent of total employment, the total number of vulnerable jobs may be estimated at around 10 per cent of total employment.
4. The new tax system, with a higher deductible threshold, will increase the take-home pay of low-skilled workers and may exert a moderating impact on wages.
5. OECD *Economic Survey, Slovak Republic*, June 2002.
6. For the year ending 31 December 2002, the National Bank of Slovakia reported a loss of SKK 24 836 million, with revenues of SKK 45 104 million and costs of SKK 69 940 million. The losses originated mainly from foreign exchange transactions (see table below). For 2003, a loss of similar size can be expected.

Revenues and costs of the NBS in 2002-03
(SKK millions)

	2002	January-September 2003
Financial revenues	44 897	30 183
Realised exchange rate gains	15 463	16 294
Unrealised exchange rate gains	–1	17
Financial costs	–67 946	–47 368
Realised exchange rate losses	–31 832	–24 716
Unrealised exchange rate losses	–7 513	–5 098
Operating revenues	207	143
Operating costs	–1 994	–1 315
Total loss	**–24 836**	**–18 357**

Source: National Bank of Slovakia.

7. Among Czech Republic, Hungary, Poland, Slovakia and Slovenia.
8. For the general government sector and on basis of government financial statistics (GFS).
9. The true level of public liabilities in 1993 was probably non-negligible, if one factors in the commitments resulting from bilateral agreements with the Czech Republic on the division of federal liabilities, and the implicit debt of the pay-as-you-go (PAYG) pension system.
10. The deviations of the 2003 expenditure and revenue outcomes from the budgeted and projected magnitudes are unevenly captured by existing methodologies. Certain non-tax incomes are not considered as current revenues and should be treated below the line in the ESA-95 methodology, while the continuing build-up of arrears in the education and health sectors are not properly recorded in the cash accounts. Transparency problems remain in the consolidation of the general government revenues and expenditures under decentralisation, and the quality of the 2002 and 2003 accounts is severely affected. These measurement problems are making difficult the accurate monitoring of the fiscal stance.
11. Historical and recent fiscal data is available on a GFS basis, while government's plans and projections are prepared on an ESA-95 basis.
12. The Ministry of Finance estimates that savings in government non-wage consumption of up to 1.5 per cent of GDP are technically possible within a four years horizon.
13. The authorities sought international assistance in analysing the long-term fiscal pressures and assessing available reform options with an aim to transfer the modern techniques of medium-term fiscal budgeting, functional programming and treasury and debt management in Slovakia. The Ministry of Finance (MOF) announced in April 2003 that the World Bank (WB) will provide a US$5.6 million 4-year loan for fiscal reform. Although its terms have not been specified, the loan will be earmarked for projects aimed at supporting the process of preparation of state budgets. This should include the improvement of the macroeconomic analysis and governance of the state treasury system. The WB equally supports a project to improve the analysis of the "economic impacts of legislation" and a WB judicial expert recently joined the Ministry of Justice. The US Treasury advised the MOF in 2000-2001 for the introduction of functional budgeting and programme budgeting techniques, including through a pilot application in co-operation with the Ministry of Education. European Commission also helps with project grants and "twinning operations" between the Slovak Government and the fiscal authorities of other European Union Member countries. Finally, the International Monetary Fund (IMF) initiated recently a "Public Expenditure Review" for the Slovak Republic.
14. Social security contributions will be reduced from 50.8 to 46.5 per cent of total wage costs as of January 2004. Further cuts will be needed in the future to reduce the high unemployment rate. Both labour tax wedges and labour supply-demand imbalances are largest of the low end of the labour market and need to be urgently addressed (see Chapters Iand IV).
15. Partly hidden in Slovakia because of the off-budget payment arrears in the hospital sector, which are periodically "cleaned" by the government. These arrears reached 1.5 per cent of GDP in 2002 alone.
16. Among Czech Republic, Hungary, Poland, Slovakia and Slovenia.
17. The old-age dependency ratio is at present around 15-16 per cent against more than 20 per cent in other post-transition countries.

18. The country has a small size and no natural obstacles fragment the territory. Should transportation shortcomings be remedied, eastern regions could rapidly be fully integrated in the national economy and share its attractiveness as an investment location in Central Europe. Latest investor surveys confirm the discouraging impact of the transportation bottlenecks.
19. The health status of the population depends only partially on the quality of health services. It is equally influenced by factors such as income levels, education, nutrition, working conditions, etc.
20. World Bank monograph, 2002.
21. In the ESA-95 methodology and excluding bank restructuring costs. The deficit was planned to decrease from 4.7 to 3.3 per cent of GDP with bank restructuring costs.
22. According to a recent assessment of the road infrastructure by the World Bank "undermaintenance is eating away at the stock of transport infrastructure". To correct the current backlog in maintenance and to adapt capacities in both basic and high standard network would require a 2.3 fold increase in funding. The world Bank estimates that this situation is "unsustainable in anything more than the very short term".
23. See OECD *Economic Surveys of Slovakia*, 1996, 1999.
24. Specific chapters are created for state treasury and debt, these can be exceeded if financial circumstances require it.
25. Information by the State Audit Office.
26. Social security spending is subject to the largest overruns, notably in the health area. Health insurance funds clear their fiscal projections with the Ministry of Health, but unbudgeted cost increases, unfunded pharmaceutical bills and ex-post deficits of hospitals have became common.
27. Expenditures in the electoral year 2002 were massively exceeded by pension and wage increases voted in the course of the year.
28. In 2003, the government could use part of its limited privatisation revenues to reduce debt.
29. "Old environmental burdens" (OEB) were estimated to reach SKK 21 billion, or around 2 per cent of GDP, by the Ministry of Environment, of which SKK 12 billion for contaminated territories and SKK 0.34 billion for the sanitation of former Soviet military bases. There are also other higher estimates of environmental commitments (see section below on Sustainable Development).
30. The parameters of the pension system are not stabilised and make the calculation of pension liabilities hazardous (see below).
31. These guidelines were based on the US and European experiences with functional budgeting and on the advice given by these countries' budgetary authorities.
32. Including the Ministry of Education, the Supreme Court and the Academy of Sciences.
33. This scheme requires tariff increases of 40 per cent in residential electricity and of more than 100 per cent in residential gas. Because of the expected impact on inflation and real incomes (administered prices account for nearly 20 per cent in the consumer basket) a gradual adjustment paths is planned.
34. In exchange of the lump sum subsidies received ZSR committed to stop all informal borrowing and arrear-building, and to close 25 regional lines. It is early to tell if outcomes are conforming the terms of the agreement – as loopholes remain numerous in the railway system.

35. High risk guarantees will be conservatively reported at 100 per cent of face value.
36. See Diamond (2002).
37. Sub-central governments obtain only a very limited share of total tax revenues. This share amounted to only 5 per cent for municipalities in 2001.
38. As they do in many Slovak regions.
39. Over-reliance on central government grants may shift the focus of sub-central government actions on negotiating and bargaining for additional subsidies rather than achieving savings. The problem is frequently faced in countries using earmarked grants based on ex-post actual costs to fund local public services, notably in health, education and employment assistance areas, such as Ireland, Switzerland and until recently Italy (see Joumard and Kongsrud, 2003).
40. There is mounting evidence of arrears accumulation and unauthorised debts in the education and health sectors in 2002 and 2003, when the governance of these sectors has remained in a limbo between central, regional and local governments. Political pressures to re-open the 25 loss-making local railway lines, often mediated by regional authorities, have also intensified during the same period.
41. This is best illustrated by the transportation and communication links between Northern Hungary and Southern Slovakia which remain very weak. The first region is labour-constrained while the second suffers high unemployment. Their labour markets are not integrated and interregional mobility is low. Policy coordination for road infrastructures and labour market schemes could enhance regional welfare.
42. A senior official from the Ministry of Interior in charge of staff reductions reported that the latest amendment to the Civil Service Act creates new bureaucratic obstacles to layoffs because each case has to be consulted with the Civil Service Office.
43. The decentralisation reform in the Czech Republic is faced with the same problem.
44. In the absence of consensus with teachers' unions, the concept of a performance-based pay system for primary and secondary school teachers was abandoned in 2003. Tertiary education teachers and their institutions have been given a choice between classical and performance-based pay systems.
45. OECD, *Education at a Glance*, 2003.
46. A recent OECD assistance programme for the introduction of Internal Financial Control Systems in Slovak public administration stressed the need for re-training: "Many of our recommendations, if implemented, would represent further complex and significant changes to current working practices…In principle, a budgetary organisation will need an accounting system with much the same capabilities as a medium-sized business company… The accounting system will not only be a system for financial control but also an important tool for the management of the budgetary organisation." Need for re-training was also underlined for fighting fraud: "There is very little experience to effectively investigate fraud. Attention is to be given to adequately resourcing investigation teams and to have them provided with appropriate training" (OECD, 2003f).
47. The Central Bank recently issued a warning on the excessively optimistic character of the projections associated with the pension reform.
48. Part of recent privatisation revenues, amounting to 6 per cent of GDP, have been set aside to finance this reform. Reserve needs are larger, however, as more than 1 per cent of GDP will be diverted away every year during a 20-30 years transition period.

49. Two of these three acts have already been passed. The one which will re-define the universal benefit package is in the inter-ministerial review process and is expected to be voted on early 2004.

50. Competition in social health insurance markets has not delivered the intended cost improvements for a range of reasons. Notably, insurers, even if they are allowed to do so, have not engaged in selective contracting with providers or negotiated with them improvements in quality or better managing of care, particularly in countries where historically insurers had an obligation to contract with all providers.

51. This process will be further accelerated by the integration with the EU markets in pharmaceuticals, medical equipment and health professionals. A recent estimation of the prospective fiscal cost of wage and price equilibration in the health sector projected sizeable spending pressures from this process in the neighbouring Czech Republic. See OECD *Economic Survey of the Czech Republic*, 2003.

52. Recent surveys on perceptions of corruption by the business sector are available on the website of the Slovak chapter of Transparency International (*www.transparency.sk*).

53. In contrast, the Czech authorities appear to have been more successful to date in their combat with economic crime. A number of former high-level officials, including a former Minister of Finance, were convicted. Although both countries share high levels of corruption, the Czech legal system appears to be more robust in terms of the quality of legislation and enforcement. This may well result from the lack of a genuine legal tradition in Slovakia prior to the split of the Czech and Slovak Federal Republic at the end of 2002; until then, Czech and Slovak jurisprudence was mostly Prague-centred. The most experienced law-enforcement authorities were also based in the Czech part of the former Federation.

54. To improve the situation, the government hired 400 officials in 2003 to process routine court cases and another 200 are to be employed in 2004.

55. The government has prepared legislation to streamline appeals procedures that should become effective within a year.

56. One recent manifestation is the relatively low proportion of Slovak adults (36 per cent) who believe that the planned conflict-of-interest legislation should also apply to regional governments (*www.transparency.sk*).

57. According to the research commissioned by Transparency International Slovensko, foreign-invested corporations introduce higher standards of business ethics to Slovakia than those prevailing among domestic firms. Such demonstration effects are valuable. They are likely to be reinforced by the declining relevance of one-off "games" such as privatisation and the growing influence of repeated "games" such as continuous business activity where the mutual adherence to rules is associated with positive payoffs. See "Ako vnímajú korupciu podnikatelia", Hospodárske noviny, 27 August 2003.

58. The new regime ought to liberate the Commercial Register staff from the time-consuming burden of examining the material substance of the documents submitted, enabling them to focus instead on procedural aspects of the registration process. This implies that the market actors engaging in transactions with the newly registered firms will incur the costs of collecting information on the background of new entrants.

59. See the discussion of vulnerable jobs and the related methodological note in Chapter I.

60. See the interview with the Minister of Justice, Trend, 3 July 2003.

61. This framework is based mainly on the legislation that entails a simplification of ownership transactions (Act 175/1999), investment incentives similar to those in neighbouring countries (Act 565/2001), tax relief (Act 366/1999), job creation and retraining subsidies (amendments to Act 387/1996), support for industrial parks (Act 193/2001), and state aid (Act 434/2001).
62. In addition to SE, the group of strategic companies include entities partly sold to strategic investors (Slovak Gas Company, Transpetrol, Slovak Telecom, Slovak Insurance Company, Slovak Savings Bank) as well as fully state-owned entities (Slovak Water Company, Slovak Post, Slovak Railways and State Forest Enterprises) and state-controlled regional bus operators. The government decided recently to privatise strategic firms on a case-by-case basis, reserving the right to sell all shares. The relevant amendment to the Strategic Companies Act is yet to be approved by Parliament.
63. See Bella and Durkovic (2003) for a detailed discussion. See also "Dispute Between Slovak Telecom and eTel Continues", ISI News, August 2003.
64. See "Ability of Telecommunications Office to Use its New Powers Doubted", ISI News, September 2003.
65. In July 2002, the Telecommunication Office of the Slovak Republic granted Profinet.sk (an internet service provider) a GSM and UMTS license, after it was the only bidder for the combined GSM/UMTS license and thereby becoming the third mobile operator in the country. However, in September 2002 both the GSM and UMTS licenses were revoked as Profinet.sk failed to come up with the first installment of the license fee in time.
66. With an annual consumption of more than 40 GWh.
67. As of 30 June 2003.
68. Actually, some households have apparently experienced large price increases along with deteriorating service standards. The plight of consumers dealing with monopolistic energy distributors has often been described in the Slovak daily press. See *e.g.* "Energetika zostáva monopolom", H*ospodárske noviny*, 7 May 2003.
69. This persuasion by the competition authority was successful in the case of the power industry where the transmission grid was split from the dominant generator and controlling stakes in regional distributors sold to different strategic investors. However, the gas utility (SPP) was privatised as a whole.
70. For instance, this highest court of appeal reversed in June 2003 a competition authority decision detecting an abuse of dominant position by the incumbent telephone operator (ST).
71. This distribution is based on NBS statistics pertaining to newly drawn loans in the non-financial business sector for the first 4 months of 2003. No comparable data are available for earlier periods.
72. For details of the loan programme schemes see National Agency for Development of Small and Medium Enterprises (2002), pp. 46-7.
73. The completion of this project has been time consuming because of consultations and co-operation between existing supervisory authorities.
74. Kontinuita had 5 per cent of the life insurance market in June 2003.
75. The maximum compensation awarded to a car accident victim in Slovakia last year was about 4 times higher than the maximum amounts awarded by courts in Germany or the

United Kingdom, 10 times higher than the maximum amount in Spain and more than 20 times higher than in the Czech Republic. See Trend, 12 June 2003.

76. As of 30 June 2003.

77. In no-fault auto insurance regimes, there is no fault assigned in the case of an accident. The drivers involved submit claims to their own insurance companies and receive immediate compensation from them without any involvement of lawyers, courts and judges. Interpretable damages (pain, emotional distress, etc.) are usually not covered while compensation for injuries is restricted by pre-determined limits. No-fault auto insurance regimes are operated in some states of the US and British Columbia in Canada.

78. The mandatory buyout price cannot be less than the average stock value during the last 6 months preceding the takeover. In the Slovnaft case, the average share value was boosted from SKK 1 093 to SKK 1 379 by a single transaction taking place five days before MOL bought the majority stake. MOL asked Financial Market Authority for the approval of the takeover bid with the price of SKK 1 200 per share; this offer was rejected by the Financial Markets Authority. MOL subsequently asked Financial Market Authority for the approval of the takeover bid with the price of SKK 1 379 and this offer was accepted on 29 October 2003. However, MOL had not initiated the approved takeover bid by December 2003.

79. "Conservative", "Balanced" and "Growth-Oriented" pension funds are distinguished. Funds with higher risks will only be accessible to contributors with a long-term investment horizon, *i.e.* those remote from retirement. Persons near retirement will be allowed to invest in the safest instruments only.

80. Rather than creating a new and necessarily less experienced authority.

81. The previous OECD *Economic Survey of the Slovak Republic* (2002) included a special chapter on the labour market, focussing on high unemployment and the development of human capital.

82. The same ratio in other OECD countries with large government sectors amounts to 14.5 per cent in Spain, 16 per cent in Italy, 18 per cent in Portugal and 18 per cent in Belgium, all below Slovakia. France has a slightly higher ratio at 23 per cent.

83. The share of disability benefit recipients in the working-age population observed in Slovakia exceeds the comparable proportion in the Czech Republic, a country with similar rules, by 3½ percentage points.

84. The Slovak authorities now require at least one verified job application in the two-week reporting period. Many small businesses have reportedly reacted to the influx of unemployed job seekers by refusing to accept their job applications to reduce processing costs; others have started to provide bogus attestations in exchange for illegal side-payments.

85. According to a report prepared by the Trexima company (*www.trexima.sk*) for the Ministry of Labour, Social Affairs and Family, the share of the minimum-wage earners in the final quarter of 2002 ranged from 0.8 per cent in the Bratislava region to 1.5 per cent in the Presov and Trnava regions.

86. 2 per cent of households live in apartments that are subject to rent regulation.

87. See "Informácia o nákladoch na dopravu a ich vplyv na flexibilitu pracovného trhu a územnú mobilitu pracovnej sily" 25.03.2002, *www.employment.gov.sk*.

88. The insufficient capacity of Slovak universities has resulted in growing enrolment of Slovak students in academic programmes available in the neighbouring countries, especially in the Czech Republic. The 1999 bilateral treaty has provided Slovak citi-

zens with non-discriminatory access to Czech universities, which means that they do not pay any tuition fees. Given the absence of a serious language barrier, this has resulted in a rapidly growing number of Slovak university students in the Czech Republic. Improving business environment conditions could motivate many of these students to return home after graduation. In the past, many Slovak graduates found employment in the Czech Republic, taking advantage of the 1993 labour market treaty that provides free access for Slovaks to the Czech job market and *vice versa*.

89. Unfortunately, Slovakia did not participate in the 2000 student performance assessment in 28 OECD countries so that there are no reliable comparative data on the quality of its education system. Results of the 2003 comparative assessment of the OECD countries, including Slovakia, are not available yet.

90. Many Roma have been scholarised in primary education institutions specialised in the education of children with difficulties.

91. See Ministry of Environment (2001).

92. Air pollution issues in the Slovak Republic are discussed in greater detail in OECD (2002a).

93. For example, the cost of air pollution in the EU countries was estimated to be as high as 5 per cent of GDP in the early 1990s.

94. UNECE (United Nations Economic Council for Europe) is the secretariat for the Convention on Long-Range Transboundary Air Pollution. It addressed some environmental problems of the UNECE region and has been extended by eight protocols which identify specific obligations or measures to be taken by Parties and so lays down the general principles of international cooperation for air pollution abatement.

95. Directive "Euro III" No. 98/70 of 2000.

96. This degradation of the fiscal position relates to pensions only. Ageing will put additional pressure on public finances because of increasing health care expenditure.

97. New benefit formula based on "personal wage development points" reflecting the ratio of the employee's wage to the average wage during the contribution history will tighten the link between benefits and contributions.

98. In an early estimation based on simplifying assumptions, the Ministry of Labour and Social Affairs calculated that once the new benefit calculation system becomes fully applicable, up to 4 per cent of retiring men and up to 18 of retiring women may fall in the social safety net and qualify for additional social transfers.

99. Even the increase in pensions by 6 per cent for an additional year of work would not suffice to offset the costs of foregoing pensions for one year and paying contributions at the rate of 28 per cent.

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THE LAND

Area (sq.km)	49 035	Inhabitants in major cities (end-2001)	
Agricultural area (sq. km)	24 440	Bratislava	428 094
		Kosice	236 036
		Presov	92 720
		Nitra	87 308

THE PEOPLE

Population (thousands)	5 379
Inhabitants per sq. km	110
Average annual population growth (1990-2002, per cent)	0.1
Infant mortality (per thousand live-births, 2000)	8.6
Life expectancy (2000) : Males	69.2
Females	77.4
Registered unemployment, % of the labour force	18.0
LFS unemployment, % of the labour force	18.5
Employees (thousands, Labour Force Survey)	2 127

PRODUCTION

GDP (billion SKK)	1 096.4
GDP per capita (in US$, market exchange rate)	4 406
Gross domestic investment (% of GDP)	29.8

THE GOVERNMENT

		Composition of the National Council of the Slovak	
Per cent of GDP		Republic (elections of September 2002):	
General government revenue	43.6	Movement for a Democratic Slovakia	35
General government expenditure	50.8	Slovak Democratic and Christian Union	27
Public debt	38.2	SMER	24
Official foreign debt of the government		Hungarian Coalition Party	20
and the National Bank of Slovakia	15.3	Christian Democrat movement	15
		Alliance of New Citizen	14
		Communist Party of Slovakia	11

FOREIGN TRADE

Exports of goods and services, % of GDP	71.8	Imports of goods and services, % of GDP	78.9
Main exports of goods, % of total		Main imports of goods, % of total	
Machinery and transport equipment	39.6	Machinery and transport equipment	38.2
Manufactured products	41.0	Manufactured products	28.8
Chemical products	6.9	Chemical products	10.7
Others	12.5	Others	22.3

THE CURRENCY

Monetary unit: Slovak Koruna	
Currency units per US dollar (period average)	
Year 2002	45.3
December 2003	33.5

This Survey is published on the responsibility of the Economic and Development Review Committee *of the* OECD, *which is charged with the examination of the economic situation of member countries.*

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The economic situation and policies of The Slovak Republic *were reviewed by the* Committee *on* 24 *November* 2003. *The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole* Committee *on* 16 *December* 2003.

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The Secretariat's draft report was prepared for the Committee *by* Rauf Gönenç, Peter Walkenhorst *and* Jaromir Cekota *under the supervision of* Yutaka Imai.

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The previous Survey *of* The Slovak Republic *was issued in June* 2002.